

## INTERNAL REVENUE SERVICE

Number: **INFO 2002-0094**

Release Date: 6/28/2002

Index Number: 3121.01-22



Dear [REDACTED]:

I am responding to your January 23, 2002 letter concerning the recently proposed regulations on the application of employment taxes to statutory stock options. I appreciate your concerns about the potential burdens on employers and employees. We have tried in the proposed guidance to lessen those burdens. We also hope to receive constructive comments to the proposed guidance that will allow us to further lessen those burdens. However, under the current employment tax provisions of the Internal Revenue Code (the Code), no exception exists that would exempt compensation received from statutory stock options.

Statutory stock options include incentive stock options under section 422 of the Code and stock options granted under an employee stock purchase plan described in section 423 of the Code. The application of employment taxes to statutory stock options has been an issue for many years. Before we published Notice 2001-14 on January 18, 2002, we had released a number of publicly available documents stating our position that employment taxes were applicable to statutory stock options, and had become involved in several audits as well as litigation in federal court addressing the issues. We recognized, however, that earlier published guidance had confused some taxpayers as to our position in this area.

### **Notice 2001-14**

To address this confusion, on January 18, 2001, we issued Notice 2001-14 (2001-6 I.R.B. 516) (copy enclosed). Through Notice 2001-14 we applied a two year moratorium on the application of employment taxes to statutory stock options until January 1, 2003. In addition, we allowed employers who had been paying the employment taxes to request otherwise available adjustments, credits, and refunds. We also stated our position that employment taxes applied to statutory stock options, and that we intended to issue formal guidance to clarify our position and address related issues.

We established the lengthy two year moratorium for several reasons. We hoped to provide employers and payroll processors sufficient time to establish mechanisms to administer the employment taxes. We also wanted to give the Congress sufficient time to address the issues, should it believe that such compensation should be exempt from employment taxes. Finally, we also wanted time to consider the comments we received before issuing any formal guidance.

## **Proposed Formal Guidance**

On November 13, 2001, we issued the proposed formal guidance that consisted of three items:

- (1) Proposed regulations (66 F.R. 57023 (Nov. 14, 2001)).
- (2) A notice proposing rules addressing income tax withholding and reporting issues upon the disposition of stock acquired by the exercise of a statutory stock option (Notice 2001-72, 2001-49 I.R.B. 548).
- (3) A notice proposing rules of administrative convenience to assist employers and employees in administering the application of employment taxes (Notice 2001-73, 2001-49 I.R.B. 549).

We have enclosed all three pieces of guidance.

## **Proposed Regulations**

The proposed regulations provide the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) taxes would apply when an individual exercised a statutory stock option. Because income for federal income tax purposes does not arise at the time of exercise, and federal income tax withholding is integrally tied to federal income taxes, federal income tax withholding would not apply when an individual exercised a statutory stock option.

### **Notice 2001-72**

With Notice 2001-72, we responded to concerns that applying income tax withholding at the sale or disposition of stock acquired by an exercise of a statutory stock option would be overly burdensome, especially when applying it to former employees. We propose to exempt employers from the income tax withholding obligations in this case. However, employers would still be required to make reasonable efforts to report the income on an employee's or former employee's Form W-2.

### **Notice 2001-73**

With the third piece of guidance, Notice 2001-73, we attempted to address various concerns about the application of FICA and FUTA at the time of exercise. These concerns include the administrative burdens on the employer and the potential for employees to be required to sell shares in order to fund the employee portion of the FICA tax. We propose to allow employers to deem the wages paid due to the exercise of a statutory stock option as being paid at any subsequent date or dates during the calendar year of the date of exercise. So, for instance, an employer could deem all the wage payments due to statutory stock option exercises as occurring on December 31,

resulting in one FICA calculation, return, and deposit. In addition, an employer may spread the deemed wages payments over a period of dates. So, for instance, an employer could deem the wage payment due to an employee's exercise of a statutory stock option as occurring over a six-month period, resulting in less FICA tax being withheld from any individual payroll check. Notice 2001-73 also contains other mechanisms we hope are useful for employers and employees. We hope that all of these mechanisms will assist employees and employers in meeting their employment tax obligations, and minimize the need for employees to sell shares to fund the FICA tax withholding.

I realize the regulations clarify the FICA and FUTA taxes apply to statutory stock options, and the payment of those taxes, as with any taxes, is not attractive for employers or employees. But I disagree with your conclusion we are creating a new tax. Rather, we have consistently found the Internal Revenue Code requires us to apply these taxes to statutory stock options. While we have made every effort to ease the administration of these taxes both for employers and employees, we do not have discretion under the Code to exempt compensation related to statutory stock options from employment taxes.

I hope that this information is helpful. If you have further questions, please contact me at (202) 622-6010 or Stephen Tackney of my staff at (202) 622-6040.

Sincerely,

Mary Oppenheimer  
Assistant Chief Counsel  
(Exempt Organizations / Employment Tax /  
Government Entities)  
Office of Division Counsel /  
Associate Chief Counsel  
(Tax Exempt and Government Entities)

Enclosures (4)